

ALERT

Volume VIII, No. II

February, 2008

BANKRUPTCY ISSUES FOR LANDLORDS

With fears of a recession looming, landlords are understandably concerned with the possibility of their tenants filing bankruptcy and how to minimize any resulting financial exposure. Here are some frequently asked questions regarding a landlord's rights in bankruptcy.

My Tenant Is Behind In Its Rent And Just Filed Bankruptcy. Can I File An Unlawful Detainer Action?

No. When a tenant files bankruptcy, the Bankruptcy Code imposes an "automatic stay" that prevents a third party, such as a landlord, from commencing or continuing any action against the debtor. The scope of the automatic stay is very broad and precludes any formal or informal action against the debtor to collect a debt, including filing an unlawful detainer action or attempting to terminate the lease without bankruptcy court authorization.

I Had An Unlawful Detainer Action Pending, And The Tenant Filed Bankruptcy Right Before I Got A Judgment. What Happens If I Go Ahead And Get A Judgment Anyway?

The judgment would not be enforceable because any judgment obtained in violation of the automatic stay is void. In addition, a "willful" violation of the stay could subject the landlord to liability for any actual damages suffered by

the tenant, including costs and attorneys' fees, and, in egregious cases, also for punitive damages or contempt sanctions. The courts have held that even good faith belief that the automatic stay does not apply is irrelevant in determining whether the debtor's actions were intentional.

What Are A Tenant's Obligations To Pay Rent Once It Files Bankruptcy?

The Bankruptcy Code provides a tenant with a 120-day window during which the tenant may "assume" (i.e., go forward with) or reject (i.e., not go forward with) the lease. During this time period, the tenant must continue performing its obligations under the lease (e.g., pay rent, taxes, common area obligations) until it decides to assume or reject the lease.

The Tenant Isn't Paying Rent Even Though It's Supposed To; Now What?

Although the Bankruptcy Code requires tenants that have filed bankruptcy to perform all of their lease obligations during the 120-day window to assume or reject, it is not uncommon for tenants to fail to do so. As a result, a landlord must be vigilant to ensure that the tenant is performing its obligations under the lease, and if not, to bring such breaches to the bankruptcy court's attention. A landlord that fails to act risks losing its rent and other lease payments.

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What Happens If The Tenant Decides To “Assume” Its Lease?

In the event the tenant decides to assume the lease, the tenant must cure any defaults under the lease and may continue occupying the premises and making lease payments as if the tenant had never filed bankruptcy.

What Happens If The tenant Decides To “Reject” Its Lease?

If the tenant decides to reject the lease, it must surrender the premises to the landlord. The landlord is then entitled to a claim for its lease termination damages that can be substantial. Section 502(b)(6) of the Bankruptcy Code establishes a cap on the amount of damages a landlord may claim as a result of a terminated lease for real property. Generally speaking and with some adjustments, Section 502(b)(6) caps the amount a landlord can pursue for wrongful termination as the greater of (a) one year's rent or (b) 15% of the rent for the remaining lease term, not to exceed three years of rent. Section 502(b)(6) is designed to provide some compensation to a landlord for its lease termination damages, while not permitting a claim so large as to prevent other general unsecured creditors from recovering from the tenant's estate.

What Happens To My Security Deposit In The event A Tenant Rejects Its Lease?

The security deposit must be applied to the capped amount of damages allowed under Section 502(b)(6).

Does The Section 502(b)(6) Cap Limit The Amount I Can Collect Against Someone That Guaranteed The Lease?

Assuming that the guarantor has not also filed bankruptcy, the Section 502(b)(6) cap will not limit a guarantor's obligations under the lease.

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